

# **The IMF, Economic Development, and the Promotion of Democratic Open Society\***

## **Executive Summary**

This paper explores the role the IMF should play in promoting democratic open society. It begins with a discussion of the genesis of IMF thinking on second generation reforms which emphasize the damage done by corruption, and the significance of good governance and sound institutions for economic development.

It then links this new policy approach to broader changes in thinking regarding the role of freedom, democracy, and open society in economic development. The new paradigm challenges the Fund's historic operating principle of a hard divide between economic policy and politics. The Fund's second generation reforms, especially its new stance on corruption, have been driven by arguments that governance is a core economic concern. These arguments provide a precedent and justification for greater engagement with promotion of democratic open society.

The paper then describes a range of policy interventions the Fund could undertake that would enhance economic development of democratic open societies. These include publishing country Article IV reviews, a formal statement on corruption as part of the Article IV review, a review of the state of democratic open society as part of the Article IV, increased consultation with parliaments and civil society, increased fiscal transparency, insistence on transparency of natural resource revenues, and promotion of the doctrine of odious debt to discourage looting via financial markets.

Regarding internal measures the Fund needs to build greater political sensitivity among senior management and mission staff. There is also need for greater transparency regarding Fund decision making, including the development of mechanisms showing how it has responded to external inputs.

Finally, the Fund should consider changing its Articles of Agreement to make promotion of democratic open society part of its core mission. This does not mean giving the Fund a large new mandate. Rather, it means having concerns with democratic open society embedded in its policy approach. This contrasts with the current policy philosophy which deems such concerns as inconsistent with the Articles of Association, and therefore out of bounds.

Key words: IMF, second generation reforms, economic development, democracy, open society.

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## **I The genesis of IMF second generation reform thinking**

The last ten years have witnessed dramatic changes in thinking about economic development. The old approach, substantially embodied in the Washington Consensus of the late 1980s, tended to see development as a mechanical process. The formula called for government to deregulate markets, privatize state-owned industries, and pursue policies (balanced budgets and low inflation) conducive to macroeconomic stability. Thereafter, the market would take care of the rest, attracting investment needed for development, and ensuring growth of wages and social inclusion on the back of rising productivity and income.

This mechanical model is now widely recognized as incomplete. The 1997 East Asian financial crisis, the failure to achieve sustained growth in Latin America, the problems associated with “shock therapy” applied in many former Soviet bloc countries, and the lasting collapse of many African economies, have combined to expose the model’s limitations.

In light of this, the IMF (and the World Bank) has adopted a new approach to development, often referred to as “second generation reforms.” Its argument is that first generation Washington Consensus reforms were incomplete, and need to be supplemented by second generation reforms focused on developing high quality institutions of governance that are transparent, accountable, and efficient.

The new approach is epitomized by the IMF’s changed attitude to governance and corruption, as reflected in the statement on good governance issued by the IMF Executive Board in 1997. That statement proclaims the IMF’s intent to promote good governance on the grounds that it is good for efficiency and growth. It commits the Fund to

identifying and notifying governments about areas of weak governance and their economic consequences, providing technical assistance to deal with the problems, and using conditionality where appropriate.

## **II Freedom, open society and economic development**

In many regards, the IMF's second generation reform program can be viewed as part of a broader shift in economic thinking that emphasizes the role of law and institutions in the economic process. Market economies are made, not found. They function best when regulated by good laws that are transparent and properly enforced. In effect, behind every successful market economy is a successful government.

This rethinking of government's role has in turn promoted deeper thinking about the making of good government. The Nobel laureate economist, Amartya Sen, has talked of freedom being both a "means" and an "end" of development. It is an end in the sense that freedom from material privation and personal freedom are conditions that are desirable and yield happiness. It is a means of development because freedom to choose is necessary for efficient functioning of markets, while political freedom is needed to ensure accountability of government for laws governing markets.

This conception of freedom as means and end of development is also found in the relationship between democracy and economic development. Democratic freedoms are desired as an end. As incomes rise, people demand greater political freedom, giving rise to a positive relationship between economic development and improved democracy. Equally importantly, improved democracy can promote faster economic development. This is because democracy strengthens government accountability, thereby improving the efficiency and transparency of governance. This gives rise to a positive feedback loop,

whereby development strengthens democracy, and improved democracy strengthens development.

There is broad academic and intergovernmental consensus around the main elements of democracy -- periodic free and fair elections, separation of powers, due process of law, transparency, accountability and guarantees of human rights, including freedom of expression and of peaceful assembly. Successful democracies, which both proclaim and practice these principles, are more resilient and more capable of withstanding economic and political shocks. This resilience is rooted in patterns of social relations whereby citizens have trust in each other, in the sense of sharing a common interest in society's success. Such trust has been emphasized by the democracy theorist, Robert Putnam, who sees it as reducing the free-rider problem which can undermine society's capacity to address issues requiring collective action.

A society and polity with these characteristics can be termed democratic open society. The freedoms that go with democratic open society yield happiness, making them an end of development. At the same time, they are an intrinsic ingredient for ensuring the integrity of governance. Thus, there is a positive feedback loop as illustrated in figure 1. Democratic open society contributes to economic progress, and economic progress tends to raise the demand for democratic open society.

### **III Why the IMF should promote democratic open society**

The growing recognition of the importance of democratic open society for governance and economic development poses a challenge for the IMF. This is because its Articles of Agreement have traditionally been interpreted as only allowing policies that are 'strictly' economic, thereby excluding policies related to the promotion of democracy

and political accountability. The two key articles are Article I (Purposes) and Article IV (Obligations Regarding Exchange Rate Agreements). Article I lays out the Fund's purpose – promote international monetary cooperation, facilitate expansion and balanced growth of trade thereby promoting high employment and economic development, promote exchange rate stability, avoid competitive exchange depreciations, assist with balance of payments corrections, lessen the extent and duration of payments disequilibria. Article IV expands on these themes, detailing member country obligations and Fund exchange rate surveillance procedures. The last sentence of IV.3.(b) has been viewed as especially significant, stating that the principles guiding IMF exchange rate surveillance – a key purpose - shall:

“(These principles shall) respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.”

This language is echoed in other parts of the Articles of Agreement, and it has been interpreted as supporting a hard and sharp distinction between economics and politics.

Not only is this language capable of supporting a different interpretation, it has also proved difficult to operationalize in practice. The notion of a distinction between economic policy and politics has always been something of a fiction. It is not possible to cut government expenditures, raise interest rates, change entitlements, and privatize large chunks of industry without having political effects.

That said, the fiction was easier to maintain with the earlier mechanical model of economic development. In that model, economic policy was represented as a technocratic exercise setting interest rates, budget deficits, exchange rates and exchange regimes. However, even first generation “structural adjustment” policies were marked by political

considerations, and critics of the IMF have long argued the divide was selectively and ideologically invoked by the Fund. Thus, the IMF has been prepared to call labor market reforms that alter employee rights an issue of economic policy, but it has simultaneously argued that labor standards are a political matter beyond its mandate.

Maintaining the notion of a divide between politics and economics has become even harder to sustain with the advent of second generation governance reforms. And it promises to become harder still once the relationship between freedom, democratic open society, and economic development is recognized. For the Fund the problem is that promoting development calls for an engagement with these “political” areas, yet management’s current interpretation of the Articles of Agreement renders such engagement out of bounds.

One approach to dealing with this difficulty is simply to shift the location of the divide, making policies previously deemed political now economic. This has already happened in connection with the second generation reform program, particularly as pertaining to corruption. Twenty years ago, both the IMF and the World Bank treated corruption as a domestic political matter, and they therefore resisted attending to the problem. However, empirical work has shown a robust and significant correlation between corruption and economic growth, and corruption has therefore been redefined as a core economic issue. This has enabled the Fund to engage corruption frontally.

In principle, the same logic can be applied regarding freedom and democratic open society. The positive feedback relationship between democratic open society and economic development has a sound foundation in theoretical political economy. Market

economies need government to rectify problems of market failure.<sup>1</sup> They also need government to establish, administer, and enforce laws of property and contract. Government therefore plays a critical role correcting market failures, and ensuring the operation of the market process. However, this opens the question of what prevents government failure that can result from bureaucratic failure, or capture of government by private sector interests. This is where democratic open society enters, it being the mechanism for guarding against and rectifying government failure.

Viewed from this perspective, democratic open society is an essential input for a successful market economy. Government is needed to protect against market failure, and democratic open society is needed to protect against government failure. This justifies treating democratic open society as an economic policy matter, thereby providing the rationale for IMF engagement.

#### **IV Policies for promoting democratic open society**

The previous section examined how the IMF could justify engaging with the promotion of democratic open society. This section explores the policies and tools the IMF has at its disposal. Figure 2 provides a roadmap of how the IMF can engage the challenge of promoting democratic open society. The figure distinguishes external open society promotion policies from internal Fund governance policies.

Internal policies relate to Fund procedures and organizational culture. They also include the “Voice & Vote” issue concerning country ownership and management of the Fund, and allocation of country Special Drawing Right quotas. The Voice & Vote question is an important issue in its own right, but it is not addressed in this paper.

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<sup>1</sup> The standard forms of market failure are private sector monopoly, natural monopoly, provision of public goods, and externalities arising from private actions (such as pollution).

### External policy measures

In thinking about democracy and IMF policy, the goal is not to create a large new democracy promotion mandate for the Fund. Rather, it is that concern about democracy and open society be embedded in the Funds approach to policy. Turning to specifics, external democratic open society policy measures that the Fund can adopt include the following:

- Democratic open society audits. As part of the Article IV country reviews, and as part of structural adjustment packages, the Fund should undertake democratic open society audits. These would assess the extent to which there is budget transparency; government accountability to parliaments and rule of law; freedom of the press; freedom of thought and expression; freedom of association; and free and fair elections. The justification for such audits is that -- in the words of Milton Friedman -- “freedom to choose” is critical for the efficient functioning of a market economy. So too, it is necessary to ensure that government is transparent and accountable, thereby helping guard against government failure.
- Publish Article IV country reviews. Currently, publication of Article IV country reviews is at the discretion of member governments. Timely publication of these reviews in national languages should become a condition of Fund membership.
- Corruption statement. In line with the IMF Executive Board’s statement on good governance, the Fund should also issue a stand-alone country corruption report as part of Article IV country reviews. This report would also be published in the national language in a timely manner.

- Promote civil society. Strong civil society is a key element of “deep” democracy. Civil society organizations play an important watchdog role, provide information to the public, serve as fora for debate of public policy matters, and provide voice to social interest groups. In effect, these groups are part of the social capital supporting the social relations and expectations that generate transparency, accountability, and ultimately public trust in government. The Fund can play an important role promoting civil society through consultative engagements that confer legitimacy, visibility, and status.
- Consultation with parliaments and civil society re programs. The Fund should make public consultation a mandatory element of all country assistance programs before they are approved. This would involve consulting extensively with parliaments and civil society in the design, implementation, and assessment of Fund programs. Not only would such consultation reinforce the basic underpinnings of democratic open society, it would also be a source of new ideas for policy, and provide a form of accountability check on government. Regarding which groups should be consulted, the Fund should seek out major civil society groups and those groups interested in the issues at hand. It can also seek the help of organizations such as the UNDP to identify appropriate civil society groups.
- Fiscal transparency. Transparency of government revenues, expenditures, and procurement is central to the prevention of corruption, and preventing corruption is critical for the success of both markets and governments. To make transparency effective, governments must be financially transparent to not just the Fund, but also to local decision-makers (parliaments and other branches of government), the

media, the business and labor communities, nongovernmental organizations, and the general public. The IMF should therefore further increase demands for fiscal transparency, making transparency a condition of all financial support.

- Transparency of natural resource revenues. Many of the poorest developing countries are afflicted by the “natural resource curse” – a condition whereby natural resource wealth becomes the source of corruption, civil conflict and economic stagnation, rather than growth and development. The natural resource curse is the pre-eminent obstacle to development and democracy in these countries, and the Fund must become prominent and active in shaping policies that will ensure natural resource benefits are shared widely and transparently. One opportunity is for the Fund to embrace the invitation extended by the British government, under the Extractive Industry Transparency Initiative (EITI), to be the aggregator and publisher of payments made to governments by natural resource companies.
- Publish what you lend. Countries afflicted by the natural resource curse frequently become highly indebted. In effect, financial markets are used to loot economies, with corrupt governments borrowing against future revenues which are pledged as security. The IMF should promote the creation of an international loan registry to be maintained by the Fund. This registry would record all lending (private and public) to governments and state owned enterprises, and it would also record the purpose of the loan and any pledges or guarantees given. The registry would be open to the public on the internet, and structured so as to be easily accessible and understandable to the general public. By spotlighting borrowing, such a registry

can help reduce looting via financial markets. It may also improve the efficiency of financial markets by providing better information on country indebtedness.

- Debt relief. Many poor countries are looking for debt relief. To the extent that the Fund is engaged in advocating for and providing debt relief, it should give more favorable relief to those countries exhibiting the characteristics of democratic open society.
- Odious debt doctrine. Financial markets are vital for economic development, providing needed development financing. But they are also used to facilitate looting and finance corruption. The IMF should endorse the doctrine of odious debt. This doctrine would allow for cancellation of sovereign debt where (1) lending was to regimes that came to power by overthrowing a democratically-elected government, (2) loan proceeds were not used for the benefit of the people, and (3) lenders could reasonably have known about (1) and (2). Application of this doctrine can improve the economic performance of credit markets by inducing creditors to write strict covenants regarding use of funds, and then monitoring debtors to see that they abide by those covenants. This in turn would raise growth and increase the asset base from which lenders get repaid, thereby lowering interest rates paid by developing countries.

### **Internal policy measures**

Side-by-side with these external policy measures, the Fund should adopt several new internal policy measures. These internal measures concern both process and culture within the Fund, and they represent a significant managerial challenge.

- *Build political sensitivity.* The recognition that economic policy has political implications calls for sensitivity toward domestic political conditions in client countries. Insisting on reform packages that generate political instability, particularly in fragile new democracies, is counter-productive, and contributes to failed reform efforts. Fund management therefore needs to ensure that country teams are informed regarding political considerations. A premium should be placed on assisting governments that came to power through free and fair elections, as they have earned a higher degree of legitimacy by undertaking political reforms that favor democratic open society. The Fund should start hiring professionals with the training and experience to analyze political and social forces that have a direct impact on the success or failure of Fund policies. Such change should also infuse senior management, which needs to free of a narrow economic perspective.
- *Intellectual change- labor standards.* The Fund has historically been dominated by economists, and economists have traditionally neglected politics and political institutions. Mechanical economics encouraged such neglect. The new recognition of the significance of institutions and democracy for development calls for a new perspective. For example, institutions such as labor unions are typically viewed by most economists as a labor market distortion. Yet, not only can democratic unions be characterized as correcting a market failure associated with an imbalance of bargaining power, they are also key to building counter-vailing political power and social links needed for deepening democracy.

- Transparency. Over the last decade the Fund has made documents and country agreements more public, and has broadened its solicitation of input. However, actual decision-making remains opaque, reinforced by IMF publication policies that prohibit member governments from sharing confidential IMF documents with national legislators. IMF documents should be made more transparent in a timely fashion in local languages. The Fund should also develop mechanisms that show it has listened and heard, and it should indicate how external inputs have been used.

#### **V Conclusion: time for a new core operating principle.**

For the last fifty years the IMF has operated on the principle that there exists a sharp divide between economic policy and political affairs. That idea has always been a fiction, but it was one that was easier to maintain when development policy was seen as a mechanical process in which government merely set policy dials at the right settings. This fiction has become harder to maintain in light of growing awareness of the importance of institutions, laws, and good governance for development.

The IMF has responded by redefining the boundary between economics and politics, so that issues such as government corruption, government accountability, and fiscal transparency are labeled as economic. This has proved strategically expedient. However, the time is now right for a new intellectually coherent operating principle.

Economic interventions have always had domestic political consequences. It is not possible to force budget deficit adjustments without political consequences. So too, abandonment of capital controls in the name of financial liberalization, opens a government to additional pressures from financial markets – a fact vividly illustrated in

Brazil's elections in 2002. These considerations suggest that the traditional economics versus politics operating principle should be abandoned. Instead, a 21<sup>st</sup> century operating principle should explicitly charge the IMF with facilitating democratic open society, subject to not undermining the policy autonomy of democratic governments. This formulation would leave room for policies such as budget deficit conditionality, but other policies such as financial liberalization would not be the prerogative of the Fund. Instead, they would be up to national governments. Fund policies would also be applied in ways that helped democratic governments undertake political and economic reforms, giving them breathing room to manage the transition to market-based democratic open society.

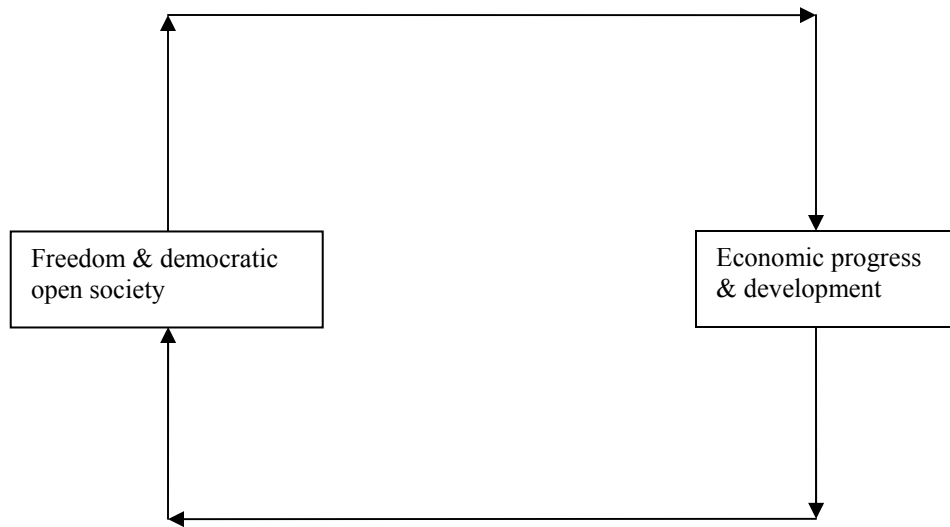


Figure 1 The positive feedback loop between economic development and democratic open society.

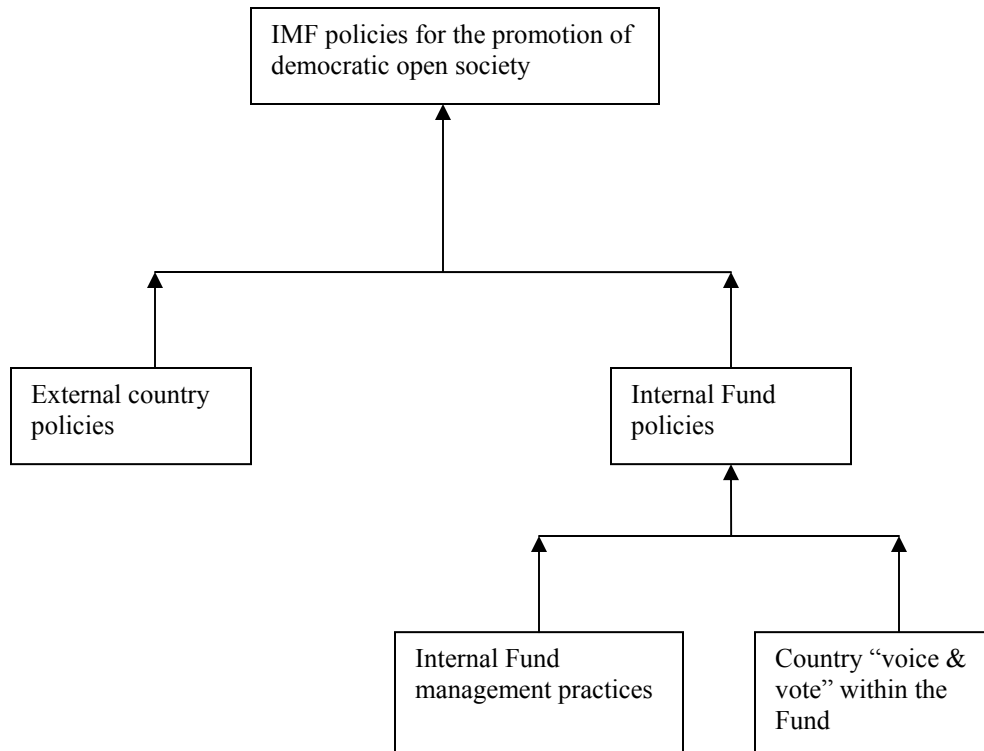


Figure 2 Description of policy areas where changes to policy aimed at improving the IMF's contribution to the promotion of democratic open society could be made.